November Economic Update: Trading the positives

Whether it's US-China trade or Brexit, the political newsflow has taken a tentative turn for the better over recent weeks. But it may be too soon to sound the all-clear, and political risks could easily flare-up again as we move into 2020. That means the slowdown in the global economy probably has further to run.

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Encouraging news from the trade front

Markets rallied earlier this week on signals that a de-escalation of the trade war is in the making. But risks are still tilted to the downside

US: The job's not done

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Eurozone: Looking for the trough

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UK & Brexit – Why 2020 could be just as uncertain as 2019

The Brexit outlook looks very uncertain, regardless of who wins December's unpredictable general election.

China: Trade war vs 5G

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Japan: What goes up

Japan is now heading into a period where the data will cease to have much meaning. It will be some months before we can see how it has weathered the latest consumption tax hike.

FX: Dollar remains in demand

The dollar had its worst month of the year in October, selling off by close to 2%. It is tempting to call this the top, but even if it is, the case for a higher EUR/USD is not particularly strong right now

Rates: Blinkers on en route to 2%

The market is sniffing a reduced recession risk. The comfort blanket of consecutive rate cuts by the Fed has helped. But the catalyst for change has come from politics. In consequence, core curves are re-steepening. With the US 10-year in this mood, we will likely see a test of 2% before we get back to testing for lower yields again

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Encouraging news from the trade front

Markets rallied earlier this week on signals that a de-escalation of the trade war is in the making. But risks are still tilted to the downside

Optimism prevails

Although it has not been the prime focus of attention, US Commerce Secretary Wilbur Ross's optimism last weekend that tariff hikes on European car imports can be avoided, signals that serious steps are being taken towards a de-escalation of the trade quarrel between the US and EU. According to Ross, there is hope that plans by European car makers to invest in the US will bear enough fruit to make higher import tariffs unnecessary.

Most of the recent market optimism, however, has been fuelled by the increasing chance of a mini trade deal between the US and China. There are still hurdles to be overcome but it is encouraging that, contrary to last spring, Chinese negotiators are sending more positive signals, as well their US counterparts.

The fact that President Trump has decided to go along with a partial deal, despite his earlier statements, is a positive sign in itself. Until recently, he said that he was only interested in an all-encompassing deal, which would be much more difficult to achieve.

This change of mind shows that Trump, as we forecasted earlier, has entered the concession phase. He needs a deal to show the American people that he can deliver on his promise to improve the terms of trade for the US ahead of the 2020 presidential election.

Last hurdles in negotiations are toughest

Having said this, it should be noted that there is still work to do. It is not yet clear whether the alleged concessions from China regarding its exchange rate policy, its policy to protect foreign intellectual property and its increase in agricultural imports from the US, will be enough to satisfy the US administration and the Republicans and Democrats in Congress. Quite a few members of Congress from both parties are afraid that Trump is giving in too much simply to be able to claim a win. Trump will be wary of cutting a deal that can be easily characterised by the Democrats as pure window-dressing with no real substance.

Even if the Chinese concessions have enough clout to potentially convince Congress, the question remains, what price is the US willing to pay? China is demanding that the US not only cancel the tariff hike planned for mid-December, but also undo a significant share of the US tariff hikes that have been implemented since the start of the trade war. Chinese officials said today that there is an agreement with the US to roll back some of the mutual tariffs hikes. How many will be rolled back depends on the final content of the mini deal, they say.

Tariffs still a potential deal breaker

While this is a positive development, the scaling back of tariff hikes could still turn out to be a deal breaker. If the US considers the mini deal as no more than a limited first step towards a phase two deal which would resolve the more difficult issues, it will want to keep the pressure on. Without sufficient tariffs in place, China's willingness to cooperate in follow-up negotiations on tough issues like reducing Chinese state subsidies, diminishing 'forced' technology transfers and scaling down its ambitions to conquer global tech markets, could be in short supply, according to the hardliners on Capitol Hill and in Congress.

Nevertheless, we do expect a phase one deal to be struck soon, which means that things are moving in the right direction. Although risks are tilted to the downside, this increases the chances that our base case, a broader agreement, will be struck around the end of 1Q 2020.

US: The job's not done

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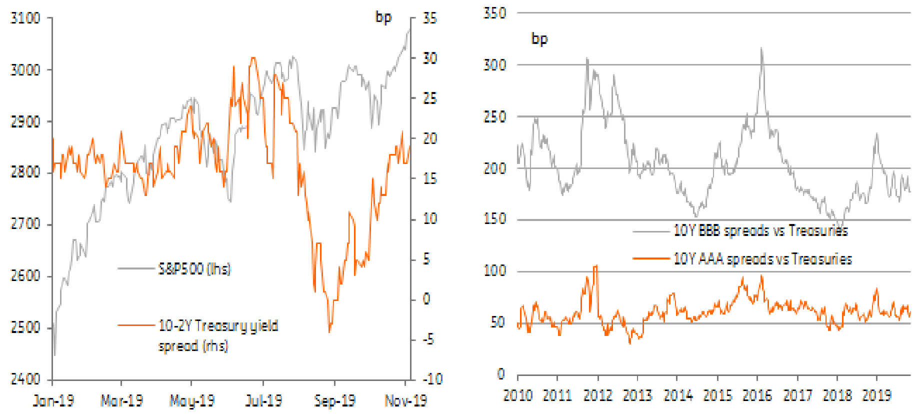
Markets are in a happy place

Looking at financial market moves since the summer you would have to say that policymakers and politicians have done a fantastic job in calming nerves about a potential US downturn. August was a rocky month with equity markets coming under pressure and the US 2-10-year Treasury yield spread inverting – a signal that typically portends a recession.

But now, markets seem to be of the view that the three rate cuts from the Federal Reserve and the easing of US-China trade tensions, backed up by stimulus elsewhere and better optics on European politics (think Brexit and Italy) means a potential crisis has been averted. After all, equities are up at all-time highs, the yield curve has re-steepened, credit spreads have narrowed and the dollar remains the currency of choice.

Fig 1 Equity and bond market optimism returns



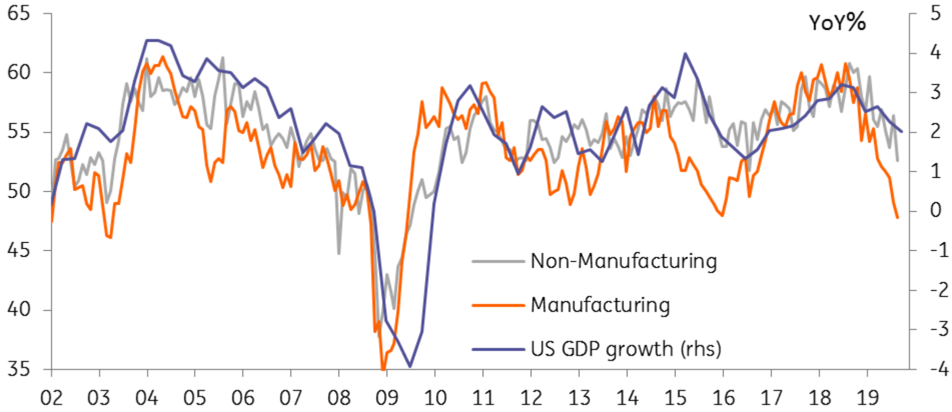
Source: Macrobond, ING

But we remain cautious

Unfortunately, we have our doubts on how sustainable this is and think there is more work to be done. The troubles facing manufacturing are plain to see. Weak global growth and trade tensions have hurt demand and sentiment with the headwinds from a strong dollar compounding the problems for US manufacturers. The ISM manufacturing index has been in sub-50 contraction territory for three consecutive months with the production component at its lowest level since 2009 while official figures show manufacturing output is down 1.6% year to date.

There is evidence that the weakness in this sector is spreading with the ISM non-manufacturing index on a softening trend and the National Federation of Independent Businesses survey at its lowest level since Donald Trump won the presidency. Moreover, business investment has contracted for two consecutive quarters with the durable goods orders report suggesting we could see a third consecutive fall in 4Q.

Fig 2 ISM indices point to slower growth



ISM surveys ask major US companies what they are seeing interms of output, order, employment, inventories, supplier delivvery times and comes up with an aggregate index of performance. #>50 = expansion #<50 = contraction

Source: Macrobond

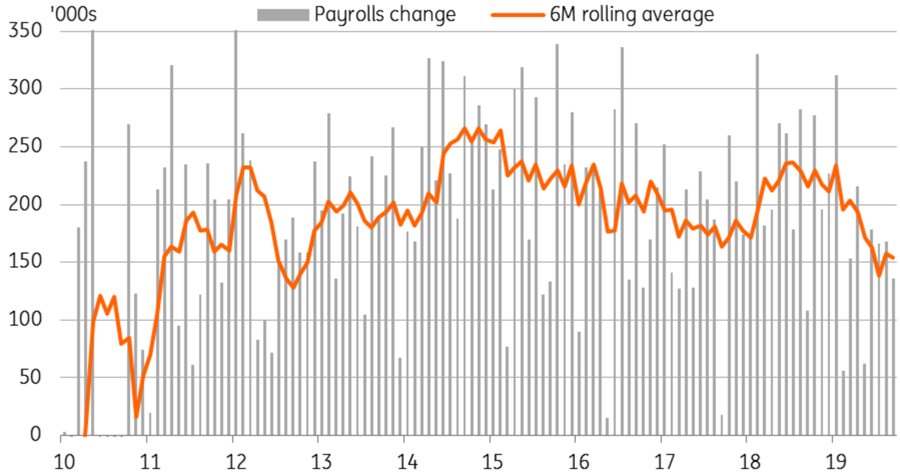
The economy is slowing, but a recession looks less likely

This indicates that businesses are reluctant to put money to work and it tallies with the slowdown in employment growth seen over the past eighteen months.
Having averaged 223,000 jobs per month throughout 2018, employment creation is running at a net 167,000 for 2019. The slowdown would have been even more marked had it not been for consecutive gains of 48,000, 45,000 and 61,000 in the leisure and hospitality sector. The fact that this one, relatively modest-sized (and lower-wage and lower-skilled) component was responsible for 30% of all the jobs created in the past three months underlines the weakness in other sectors.

The news from the consumer sector also hints at slowing growth, albeit from a firm rate. Retail sales have recently been soft and auto sales are weaker in October while consumer confidence is off its highs. With wage and payrolls growth both looking relatively modest, real household disposable incomes don't signal a major upturn in spending growth is likely. Meanwhile, the sharp increases in longer-dated Treasury yields is pushing up mortgage and other borrowing costs, which will be a headwind for consumer activity more broadly.

For now, the story is one of a gradual slowdown in US growth rather than a recession. As such the Fed has signalled a preference to pause for a while after cutting rates in July, September and October. Fed Chair Jerome Powell suggested "monetary policy is in a good place" and that they want to take stock of the impact of their actions before considering additional stimulus, which clearly hints at "no change" at the December meeting.

Fig 3 The jobs market is showing vulnerabilities



Source: Macrobond

Key risks remain

It's worth noting recent data flow has been consistent with that narrative. After all, the ISM non-manufacturing index has improved a little and the October payrolls report was not as bad as feared. With the November payrolls report set to be lifted by 40 - 45,000 after the end of the General Motors workers strike, the data should stay consistent with stable policy in December.

Moreover, the US and China look set to sign a phase one deal on trade that suspends proposed tariffs in exchange for China buying more US food and agricultural products, which is boosting sentiment. In fact, there has been some talk about the potential rolling back of some of the tariffs already implemented - the 15% tariff on around $111bn of Chinese imports (largely consumer goods) that came into effect on 1 September.

It would be in response to China making concessions on rules regarding currency manipulation and potentially also offering concessions on intellectual property protection. It would make the deal broader than initially envisaged, although we would caution that this proposal could yet be dropped with some in the US administration vocally opposing a rollback of tariffs. Either way, it would still leave significant tariffs and barriers to trade in place so it would be more of a stabilisation of relations rather than a major boost to growth at this stage.

There are other trade-related political risks. President Trump has to make a decision on whether to implement tariffs on EU made cars and car parts after postponing the decision in May. At this stage we suspect he will postpone again, not least because there is growing recognition over how significant European carmakers are to US manufacturing – for example, the BMW Spartanburg plant in South Carolina has been announced as the biggest US auto exporting plant for the fifth year in a row, and there have been significant investments by other European automakers within the US.

There is also the potential for another government shutdown with the latest short-term spending bill set to expire on 21 November. If Congress and the President can't agree a year-long budget that would get the US through to next year's elections then there is the possibility of government workers being sent home soon after Thanksgiving. We would assume neither side wants to risk taking the blame for an unnecessary and economically damaging situation to develop, but the impeachment process against President Trump could increase tensions and make reaching an agreement more challenging.

Recession risks have declined in the US, but the loss of economic momentum is clear and there is little to suggest we should expect an imminent re-acceleration in growth. Moreover, asset markets have reacted very positively to news of a trade truce and better news about Brexit and European risks. However, as you will see, our team is less sanguine about these threats.

Consequently, we feel markets and the global economy are likely to experience more bumps in the road. We, therefore, think it is too soon to sound the all-clear on downside US growth risks and with inflation and inflation expectations looking benign, we continue to see scope for the Fed to cut rates twice more.

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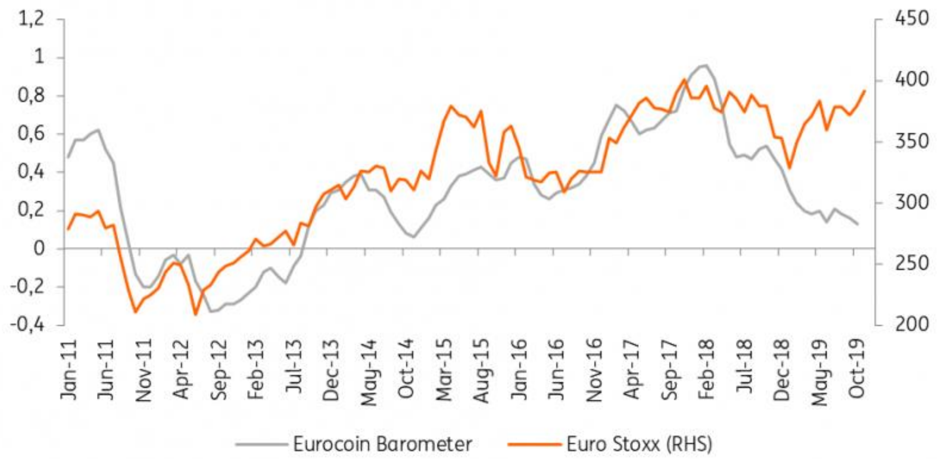
Eurozone: Looking for the trough

At 0.2%, quarter-on-quarter third quarter Eurozone GDP growth came out better than expected. However, the economy continues to decelerate and it looks as if the trough in the current slowdown might still be a few months away. With a new president at the helm at the ECB, monetary policy is unlikely to change over the forecasting period.

Anticipating a turnaround

European Stock markets have been rallying in October on the hopes that some of the outside risks are diminishing and a turnarond in activity is around the corner. That said, the €-coin indicator, a nowcasting tool for the Eurozone, fell from 0.16 in September to 0.13 in October, continuing its downward trend. The forward-looking indicators in the European Commission's business and consumer survey don't signal an imminent turnaround in the weakening trend either. Especially the manufacturing sector continues to suffer, with both the order books and the employment expectations component further declining. The now for nearly two years falling capacity utilization doesn't bode well for business investment and it is clear that as long as there is not more certainty in terms of the trade war and Brexit, businesses will be reluctant to initiate new projects..

Fig 4 Stock market anticipates a turnaround



Source: Refinitiv Datastream

Contagion from weak manufacturing

The bad news is that services now also start to feel some impact of the slowdown in manufacturing, with the sentiment indicator now below its long-term average. But on the positive side, it must be noted that hiring intentions are still holding up. And that is important, as a still good-looking labour market is supporting private consumption. The unemployment rate was unchanged at 7.5% in September, still the lowest level since July 2008. But consumer confidence is of course also important and here things start to look a bit shaky, too. Consumer confidence fell in October to the lowest point since December 2018 and is now also below its long term average. Since the summer months household started to worry more about the labour market. No wonder that the savings ratio has been creeping up and without any confidence boosting event this trend is likely to continue, putting a brake on consumption growth. On the other hand, construction activity still seems to hold up well, boosted by the very low level of interest rates. Both order books and employment perspectives actually went up in October in the construction sector.

Only gradual fiscal stimulus

The new ECB-president Christine Lagarde called upon the countries, that have the room for manoeuvre, to use their budget surpluses to fund public investments. While the Netherlands has already put in stimulus in the 2020 budget, this is more modest in Germany and the German government is unlikely to contemplate more stimulus, as long as there is no significant deterioration in the labour market. To be sure, the first signs that employment growth is over the top are popping up, but it we might already be well advanced into 2020 before the German government decides on more stimulus.

Recession avoided

We still believe that the current downturn will not degenerate into an outright recession. The combination of easy monetary policy and some fiscal stimulus, together with a trade truce and a clean Brexit, will support a cyclical improvement in the course of 2020. Not enough to lift growth above 1% though (we expect 0.7%) and given the importance of an improvement in terms political uncertainty, the risks to the outlook are still downward.

Fig 5 Employment perspectives

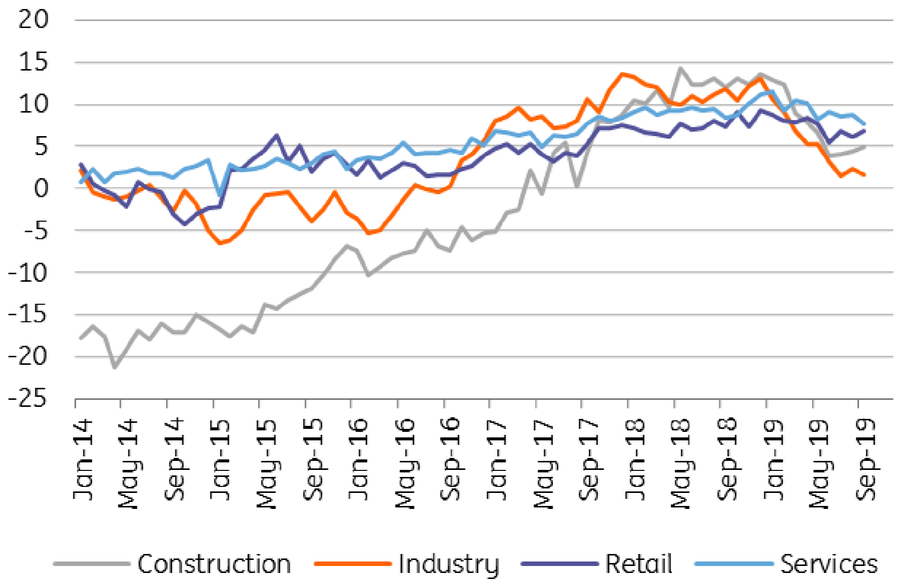
Source: Refinitiv Datastream

Yield curve steepening

Eurozone inflation fell to 0.7% in October. However, this decline was mostly due to lower energy prices. Underlying inflation actually slightly increased to 1.1%, though this is still significantly below the ECB's target. Given the growing dissent in the ECB's Governing Council we hardly see a possibility for more stimulus and the overall feeling is that the marginal positive effect of more monetary easing would be annihilated by the growing negative side-effects. It also looks that a big review of the ECB's strategy is underway, which is likely to dominate discussions within the Governing Council for some time to come, with monetary policy to remain on hold in the meantime. While we believe that the yield curve is likely to steepen in 2020 on the back of the expected cyclical improvement, we wonder whether the recent increase in bond yields has not been a bit premature. Expect bond yields to bump close to their recent lows for a few more months before a weak upward trend might materialize.

future. That means that money market rates will remain firmly in negative territory until at least the end of 2021, while it will likely also take some time for the German 10 year Bund yield to rise above 0%.

Inflation expectations soften



Source: Refinitiv Datastream

UK & Brexit – Why 2020 could be just as uncertain as 2019

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The Brexit outlook looks very uncertain, regardless of who wins December's unpredictable general election. Under a Conservative majority, fears will grow about the length of the transition period. Initial optimism about a second referendum under a Labour government could be tempered as several logistical hurdles come to the fore

The forthcoming UK election will be highly unpredictable.

UK voters will head to the polls on 12 December in what promises to be a highly unpredictable general election. Prime ministers Boris Johnson hopes that if he can secure a majority in Parliament, he'll have an easier time of ratifying his deal in January, enabling the UK to leave the EU in January.

The good news for him is that the Conservatives are comfortably ahead in the polls, despite missing his "do or die" October 31 deadline. In fact, while a recent poll for The Times found that 57% of leave voters were left disappointed by that, 63% of them think the missed deadline wasn't Johnson's fault "at all" (according to a separate YouGov poll).

But there are undoubtedly risks for Mr Johnson – not least in Scotland and parts of Southern England, where the Conservatives are vulnerable to a surge in support for pro-remain parties. There is also plenty of uncertainty over how the Conservatives will fare in 'Labour Leave' seats – a lot will depend on whether opposition parties can shift the narrative away from Brexit and back towards domestic issues.

Rising uncertainty about the length of the transition period

Even if the Conservatives do win, the size of their majority will matter. That's because if the deal is swiftly ratified, focus among businesses and financial markets will quickly turn to the transition period. This standstill phase, where the UK's EU trading relationship will remain virtually unchanged, currently expires in December 2020. That will almost certainly need extending – it's unlikely to be long enough to negotiate a new free trade arrangement, nor set up the associated border infrastructure to keep trade moving.

The EU is open to an extension to 2022, but the UK will need to sign up to EU budget payments beyond 2020 – a steep political price for Johnson. Negotiations will undoubtedly be messy, and time will be short – the EU wants it wrapped up by the end of June.

We suspect an extension is ultimately inevitable, although this will undoubtedly infuriate hardline pro-Brexit Conservative MPs. However with a sizable majority, PM Johnson may judge this a manageable risk to take.

Things look a little more uncertain if the Conservatives only scrape through the election with a very narrow majority. PM Johnson will be under heavy pressure not to commit to EU budget payments, and in the meantime that will create an uncertain backdrop for firms. If the transition period is not extended by the EU's June deadline, then there is a risk that the UK (excluding Northern Ireland) could abruptly leave the single market and customs union at the end of 2020 – a scenario not dissimilar from 'no deal' for many firms.

Don't rule out a Labour minority government

What happens if the Conservatives fail to get a majority? Well it all depends on the numbers, but there is no guarantee Johnson will be able to re-secure the support of the Democratic Unionist Party (DUP). If he can, then that will almost certainly come with the cost of renegotiating his Brexit deal. But after three-years of impasse, we doubt fresh talks would yield much greater success in getting the EU, the DUP and the rest of Parliament to sign-up to a different deal.

If the Conservatives fail to form a government, then Labour, who have a wider pool of potential Westminster partners, will try to build a working majority themselves. Other opposition parties are very reluctant to enter a formal coalition with Labour leader Jeremy Corbyn - wary perhaps it might not be long before we get another election.

However, most expect some kind of informal agreement, at the heart of which will be a commitment to holding a second Brexit referendum. That would initially be good news for financial markets, particularly given that Labour's informal Westminster parties are unlikely to sign-up to its bolder economic policy pledges.

Just how straight forward is a second referendum?

But that initial optimism could be tempered slightly as the logistical hurdles associated with organising a second referendum come to the fore. This is particularly true if Labour's working majority relies on a number of Westminster parties, and is therefore vulnerable to any one of them pulling the plug on the government. This raises a number of potential challenges:

1. A second referendum would most likely take at least six months to arrange, requiring an Article 50 extension beyond June. That would presumably require the government to quickly reach a deal on paying into the EU budget beyond 2020.

2. What Brexit deal will go on the ballot paper? Labour has said it will renegotiate with the EU, presumably at least to include future customs union access. But will all of Labour’s Westminster partners be happy with this? Don’t forget virtually all of these parties will be vocally supporting remain, creating unusual negotiating incentives

3. If Labour is reliant on the Scottish National Party (SNP) for its working majority, then Corbyn will be under heavy pressure to allow another Scottish independence referendum. The SNP will likely insist this happens before a second Brexit referendum, but Labour will push hard for it to come later, in the hope that a softer Brexit or 'remain' outcome will see independence support dissipate.

4. If the public backs leaving with a deal in a second referendum, Labour could feasibly lose the support of many opposition parties and that could easily trigger another general election. That would leave the victor to implement the public's Brexit verdict.

A very uncertain 2020
Whatever happens in this election, the outlook for 2020 holds plenty of uncertainty. That means that investment is likely to remain constrained, even if the deal is ratified in January. We're pencilling in around 1% growth for 2020, and that probably means the Bank of England will keep interest rates on hold for the foreseeable future. Once an Article 50 extension is secured, the countdown to a general election – perhaps as little as five weeks later – will almost certainly begin.

China: Trade war vs 5G

While the US-China trade dispute is unlikely to be fully resolved next year, 5G infrastructure and services will be a new growth engine for China's economy in 2020

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Risks and opportunities in 2020

In 2020, we expect the risks associated with the trade war to be just as significant as the opportunities provided by 5G.

Trade war still the key risk

We believe that any trade agreement in November will be small, with most of the current tariffs likely to stay in force. Chinese exporters, and the related supply chains, will continue to be affected.

In 2020, there will still be a lot of uncertainty over the signing of trade deals and questions about whether these might be later overturned, by both sides.

The impact of the dispute so far has been significant. In the five months to September, China's exports showed negative yearly growth. The value of exports and imports declined by CNY566 billion in the first nine months of 2019 compared to the same period of the previous year. This may look relatively small but that's just the trade value; manufacturing activity has not been counted. In the eight months to October, the manufacturing PMI fell below 50, signalling a contraction in the sector. This has been reflected in slower economic growth overall despite sizeable fiscal stimulus.

We believe the trade war situation will continue to pose a threat to exports and manufacturing activity in 2020.

5G is the biggest opportunity

That said, 5G presents opportunities. Semiconductor sales have increased on a monthly basis since June 2019, and as we stated in our electronics report, we think this is due to 5G.

China is in the process of building 5G infrastructure in its home country and is exporting to other economies, too, which will likely be the growth engine for semiconductor sales.

There will be more than 130,000 5G base stations by the end 2019 to support the 5G network. It is estimated that China will have 170 million 5G subscribers by 2020. This only covers 12% of the 1.4 billion population, so we'll inevitably see more 5G stations being built.

Meanwhile, Chinese smartphone brands have already entered the 5G smartphone market. We expect most consumers in the big cities to upgrade their 4G phones to 5G. This means that 5G applications will probably surge. The market is already anticipating new smartphone games, new video streaming services and most importantly the "internet of things".

It is estimated that 5G will stimulate growth in China by 15 trillion yuan over the next five years. On average, it should contribute nearly 3% of nominal GDP each year (using the estimate of nominal GDP at 99 trillion yuan).

Big fiscal stimulus still needed?

For 2020, it is key that the government avoids piling up unnecessary debt after a surge in issuance in 2019.

As trade deals are unlikely to be fully completed, we believe that the central government will extend the tax and fee cuts for another year, which were worth around CNY2 trillion in 2019.

Most of the stimulus money for infrastructure projects came from the issuance of local government special bonds. For reference, the local government special bond quota for 2019 was 2.15 trillion yuan. Railway investments increased by 13.6% year-on-year on average in the first nine months of 2019.

Total fiscal stimulus is estimated to be in the range of CNY2 trillion to CNY3 trillion in 2020.

Will monetary policy go in tandem with fiscal stimulus?

The central bank seems to have been reluctant to flood the market with liquidity, seeking to avoid a repeat of 2009 when liquidity boosted speculation in various assets, including the real estate market.

As such, we think the PBoC will cut interest rates and the Reserve Requirement Ratio only when interbank rates are high, which could be measured by 3M SHIBOR over 3% on a consistent basis. Thus we expect the bank to cut interest rates once, by five basis points, and the RRR twice, each by 0.5 percentage points, in 2020.

Where is the yuan heading?

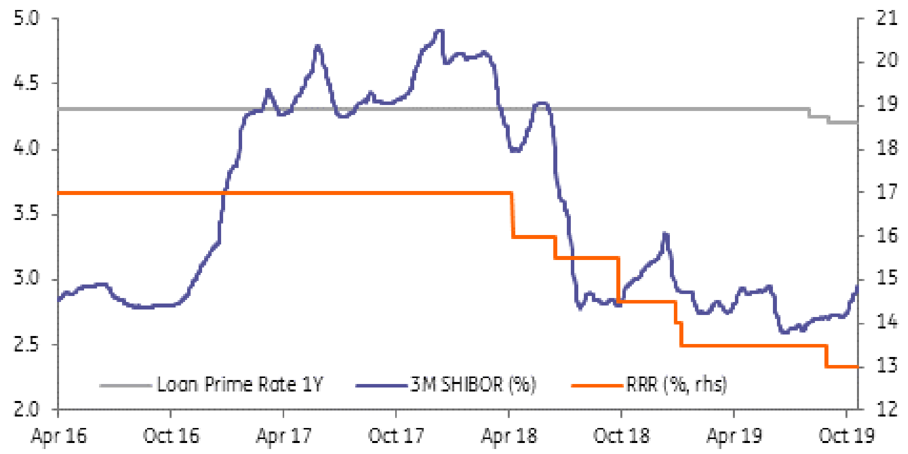
Both China and the US seem to be more willing to work out a deal than we previously expected. Though we don't think the September tariffs will be rolled back in phase one of the trade deal, this could still happen as we move closer to the US presidential election, which would support the yuan.

Our revised forecasts on USD/CNY are 7.00 and 6.85 for the end of 2019 and 2020, respectively. We would like to highlight that uncertainty about a trade deal is high and USD/CNY is likely to remain volatile.

GDP forecast

We expect the Chinese government to call for GDP growth in 2020 of "around 6.0%" when this is announced in March. Our forecast is for 5.9% growth next year. But this forecast depends a lot on the progress of trade talks.

Fig 6 Chinese rates



Source: ING, Bloomberg

Japan: What goes up

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Japan is now heading into a period where the data will cease to have much meaning. It will be some months before we can see how it has weathered the latest consumption tax hike.

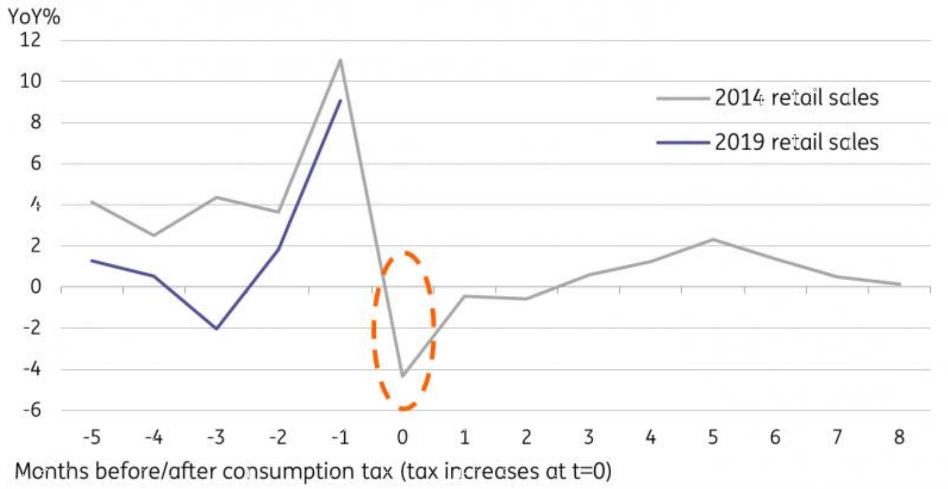
Tokyo...do we have a problem

It's a bit like when a space shuttle returns to earth, there is a period when communication ceases, and there is a heart-stopping period when you just can't tell if the crew has made it safely back or not. This is roughly where Japan's economy is right now.

Retail sales point the way

Japan's consumption tax hike from 8% to 10% in October is now a reality, and the data is now beginning to show us how this is beginning to affect the economy. So far, all we have is some limited sales data for September, the month before the tax increase came into effect. Next month we will also see consumer prices soar, with inflation perhaps even exceeding 2.0%. This is about the only way Japan can achieve 2% inflation though.

Fig 7 Retail sales in 2014 and now



Source: CEIC, ING

Cannibalism ahead and after the tax rise

Looking at the behaviour of retail sales now, and when the consumption tax was last raised, back in April 2014, the path is somewhat similar. Though we would note that this time round, the bounce in September, delivering a 9%YoY increase, is coming from a much lower base. To some extent then, not only is some of this September growth likely to be cannibalizing what we will see in October, when we will probably see sales slump by 4-6%YoY, but it also looks as if it is cannibalizing sales ahead of the tax hike too.

Acid test will come by Jan 2020

The real acid test for how the economy is weathering the consumption tax hike will come from the speed with which the economy recovers. If 2014 is any guide, retail sales will return to growth by January 2020, about three months after prices increased.

BoJ policy changes - seem very unlikely.

In the meantime, any thoughts about a change of policy from the Bank of Japan are seriously wide of the mark.

Even if it did look as if the economy had suffered more than a temporary setback from the tax hike, we remain highly doubtful that the Bank of Japan has anything up its sleeve that it can deploy to make things better. Its four stated options are:

1. Expand asset purchases – either in size or scope – though it isn't even doing what it claims is its current target, so this looks dead in the water.

2. Expand the monetary base (but this is essentially the same as 1 above – double-counting, there are really only three options)

3. Reduce the policy rate further into negative territory (but how to do this without having to ring-fence most bank reserves to exempt them and not crush banks interest margins is an open and as yet unanswered question).

4. Target negative bond yields (they are already negative and hurting Japan's population of savers.

The next four to eight weeks will provide more information, though we won't really have much clue what is going on here until next year.

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FX: Dollar remains in demand

The dollar had its worst month of the year in October, selling off by close to 2%. It is tempting to call this the top, but even if it is, the case for a higher EUR/USD is not particularly strong right now

Yield curve steepens, dollar weakens

A combination of a better trade environment and softer US activity data saw the dollar sell off 2% in October. Activity currencies performed well, while a little more clarity on Brexit saw GBP lead European currencies higher across the board.

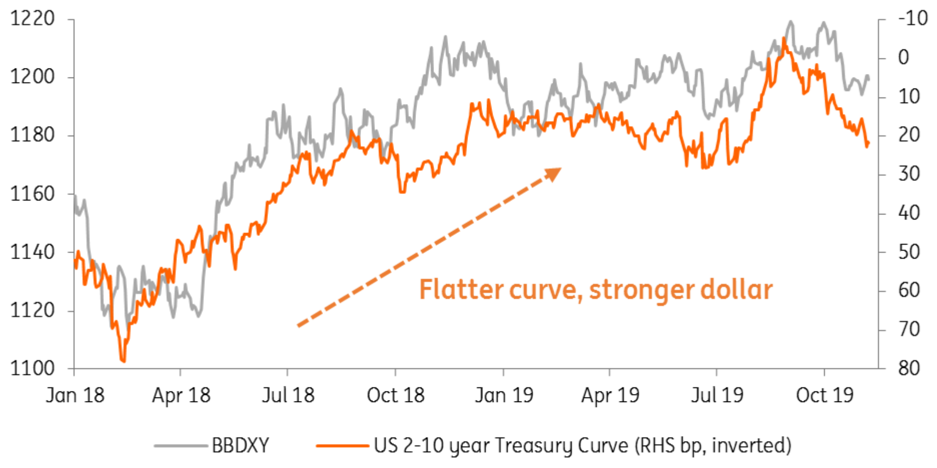
Once again the dollar moved in tandem with the US 2-10 year Treasury curve, which has proved a good barometer of secular stagnation fears this year. The third Fed cut and the détente on trade saw the curve steepen on optimism and activity currencies recover on the view that parking money in USD deposits was not the only game in town.

For the dollar to fall a lot further, however, would seem to require a big extension in some of these themes, such as:

1. US activity data deteriorating so significantly that the market prices a much deeper Fed easing cycle or
2. Much better activity data emerging overseas.

We tend to think the former is more likely than the latter (where European and Chinese activity still looks subdued), but our rates team are not big fans of the US 2-10 year yield curve steepening beyond this year's range high of 30bp just yet. As such, we think it a little premature to be calling the dollar a lot lower – especially against the low-yielding EUR and JPY.

Fig 8 Dollar turns lower as US 2-10 year Treasury curve steepens



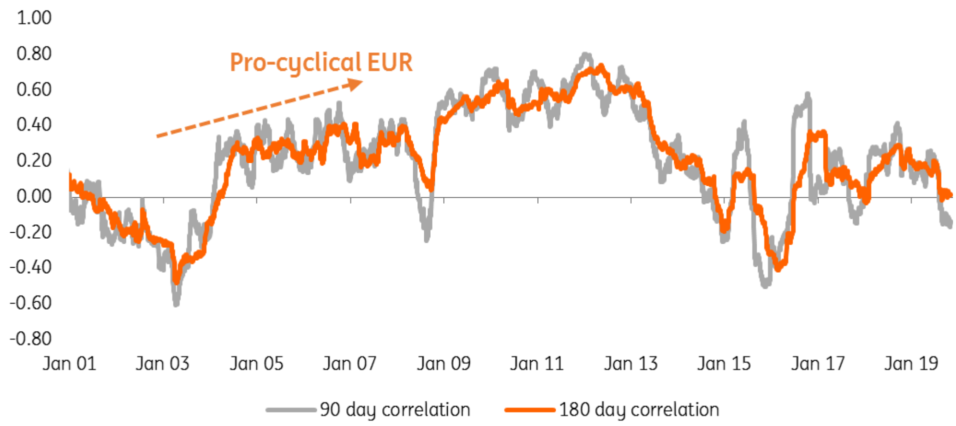
Source: Bloomberg

The drivers of the EUR are changing

Given the Eurozone's exposure to the global trade cycle, the euro has typically been seen as a pro-cyclical currency. Here, trade and the manufacturing sectors are seen as inextricably linked, based on the weight of intermediate goods in trade volumes. And for much of the last two decades, EUR/USD has had a positive correlation with world equity indices. 'Risk on, dollar off' has been a familiar refrain.

However, over the last several months, the positive correlation between EUR/USD and world equities has broken down. In fact, the 90-day correlation in changes between the two is now firmly negative. This relationship may have been distorted by the gyrations in GBP, but the move to a negative correlation is one which certainly bears watching. It warns that even if we do receive further positive developments on US-China trade - and equities rally - EUR/USD may not be a big beneficiary. This may be because the EUR is transitioning into a funding currency.

Fig 9 EUR/USD daily correlation with MSCI world equity index



Source: ING, Bloomberg

The EUR as a funding currency

It is early days, but the EUR seems to be adopting the characteristics of a funding currency. We first highlighted this in our article 'EUR: Misleading indicators, portfolio flows and hot money', particularly with developments in the FX options market.

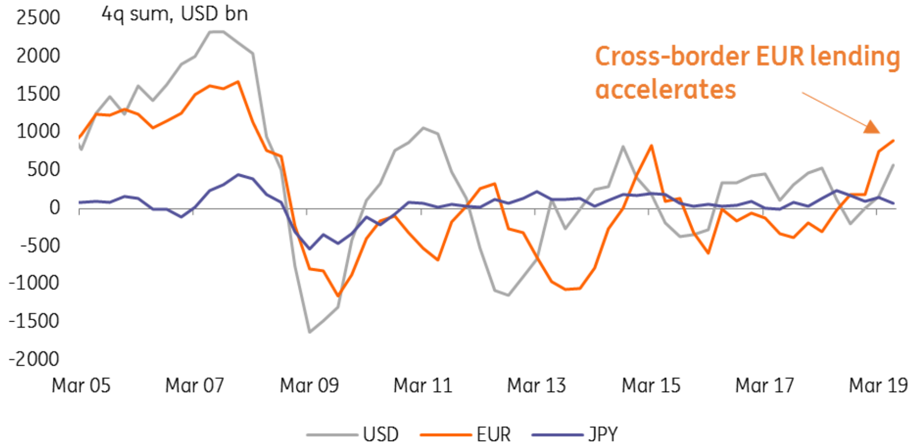
The BIS has recently released another set of data which tends to support this view. Here the locational set of banking statistics provide insights into cross-border borrowing by currency. The BIS provides an FX-adjusted set of quarterly figures, which we produce below.

Despite secular stagnation fears, total cross border borrowing on a year-on-year basis is actually rising at the fastest rate since the global financial crisis. And leading the charge is cross-border borrowing in the EUR. Over the last twelve months, participating banks report that their cross border lending in EUR has risen by near US$900bn, while USD lending has risen by around US$550bn.

It would seem that the EUR is becoming the preferred borrowing currency of choice, enjoying good liquidity, low volatility and most importantly, little risk of interest rates rising anytime soon. We've seen these trends emerge and weigh on the likes of the JPY and the CHF over the last two decades and see early signs of the EUR of crossing the floor to join these funding currency peers.

This would suggest that even if the risk environment does improve a lot, EUR/USD would lag. That's why we see EUR/USD continuing to trade near the 1.10 area over the next several months and only see limited upside – perhaps to the 1.15 area towards the end of 2020.

Fig 10 EUR cross-border lending takes of



Source: ING, Bloomberg

GBP and the election

Elsewhere we expect GBP to consolidate ahead of the December 12th election – this because positioning is better balanced now and the volatility and quality of opinion polls will prevent large new positions being set. That probably means a 1.25-1.30 range for Cable and an 0.85-0.88 range for EUR/GBP. We'll publish post-election GBP scenarios in a separate article.

Rates: Blinkers on en route to 2%

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The market is sniffing a reduced recession risk. The comfort blanket of consecutive rate cuts by the Fed has helped. But the catalyst for change has come from politics. In consequence, core curves are re-steepening. With the US 10-year in this mood, we will likely see a test of 2% before we get back to testing for lower yields again

There has been a change in the air of late. It started a few weeks ago and has manifested in rallies in risk assets alongside an upward ratchet in core market rates.

In the background, the Federal Reserve had been busy shaving the funds rate at consecutive meetings. Meanwhile, the Trump administration has been teeing up a trade truce with China, no doubt identified as part and parcel of a route to a second term in office. And prime minister Boris Johnson has managed to push Brexit into the long grass for at least another few months. Even if only briefly, all of this is enough to allow markets to breathe a little. While things are far from perfect, this combination has been enough to re-calibrate the market discount towards a more positive tint.

Quietly, the US yield curve has moved from a state of inversion to an upward sloping one. Even the 2/5yr segment, which had fired the first of the inversion warning shots, has now moved back into positive territory. It is not upward sloping by much (just 5bp) but it is enough to dumb down recession alarm bells. And as we write the 2/10yr is honing in on a 25bp curve, again, well clear of inversion. When this spread hit -5bp in late August, the Fed had begrudgingly delivered a rate cut. It has since followed that up with two more. Fast forward, add reduced imminent risk of economic suicide on both sides of the Atlantic, and the need for more immediate rate cut action from the Fed has been downsized..

> *"It seems to us that equities are reacting to what's in the rear mirror, and are prone to demanding a December rate cut as we get closer to it"*

There have been other positive developments too. The US 10-year breakeven inflation rate is heading back up towards 1.7%. This is still remarkably low (discounting inflation at closer to 1.5% than 2% for the next decade). But it is up from the 1.5% breakeven we had only a few weeks ago. The biggest driver here has been a vanilla rise in (nominal) market rates. The US 10-year is now up in the 1.8% area - a material rise from the 1.5% area hit about a month ago. With risk assets, and in particular equity markers, in good condition, there is a counter momentum out of risk-free rates like Treasuries. That could be enough to tempt the 10yr to have a go at getting back up to 2%. That is the immediate near-term call.

We'd have a preference to fade this move though. It is not that we doubt the validity of the market discount process and the evolving "positives" (or fewer negatives) surrounding global trade and Brexit. It is more a concern that the rise in market rates is also an inverse reaction to the rally in equities. Given the underlying stresses on corporate profits as evidenced from reduced investment ambitions (actual and future), it seems to us that equities are reacting to what's in the rear mirror, and are prone to demanding a December rate cut as we get closer to it, and in consequence could well see confidence crumble as the Fed increasingly makes clear that enough is enough for now.

It is in the interest of the Fed to provide money markets with as much stability as possible into the turn of the year. Why? To prevent a repeat of September which saw repo rates hit 10% as we approached the end of Q3. Back then the market needed to window dress in regulatory terms the lack of access to liquidity, and hence the rise in the price of it. Here, by avoiding any temptation on the part of money market players to wait for a possible December rate cut, such players can instead plan now for the year-end. This, in turn, should help avoid a repeat of the September spike.

"It is in the interest of the Fed to provide the money markets with as much stability as possible into the turn of the year. Why? To prevent a repeat of September which saw repo rates hit 10%"

The other technical rationale for the Fed to stay put now is they are currently buying bills and adding reserves to the system as a means to ensuring that there is adequate liquidity in play (again, a reaction to the September spike). While this is not classic quantitative easing per se, as it is so short in duration, it is still net monetary easing, which thickens the comfort blanket for the economy. The big question is whether this will all be enough as we head into 2020.

Our economists are not convinced and anticipate a resumed rate-cut risk in Q1 as the macro numbers disappoint. That backdrop would be enough to see 2% for 10yr US as a local peak (if we get there), and for 1.5% to be back on the radar screen as a theme beyond that.

So, it is still a low market rates environment, with inflation contained and questions to be answered on the state of the economy. The subtle changes in the market discount make full sense as some risks have been downsized; we are just keen to not to extrapolate too far.

ING global forecasts

	2018					2019F					2020F					2021F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	2.6	3.5	2.9	1.1	2.9	3.1	2.0	1.9	1.5	2.3	0.6	1.3	1.9	1.9	1.4	1.9	1.8	1.9	1.9	1.8
CPI headline (% YoY)	2.7	2.7	2.6	2.2	2.4	1.6	1.8	1.8	1.8	1.8	2.2	1.9	2.0	2.1	2.1	2.1	2.0	1.9	1.8	2.0
Federal funds (%, eop)[1]	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.50	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.50	1.50
3-month interest rate (%, eop)	2.30	2.35	2.45	2.65	2.65	2.30	2.00	2.10	1.73	1.73	1.44	1.39	1.39	1.39	1.39	1.50	1.79	1.60	1.84	1.84
10-year interest rate (%, eop)	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.70	1.50	1.50	1.40	1.50	1.60	1.90	1.90	1.90	2.00	2.10	2.10	2.10
Fiscal balance (% of GDP)					-4.0					-4.6					-4.7					-4.7
Fiscal thrust (% of GDP)					1.1					0.4					0.0					0.3
Debt held by public (% of GDP)					76.7					79.0					81.8					84.4
Eurozone																				
GDP (% QoQ, ann)	3.2	1.5	0.8	1.4	1.9	1.7	0.8	0.8	0.4	1.1	0.4	0.9	1.2	1.0	0.7	1.0	1.0	1.0	0.9	1.0
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	0.9	1.0	1.2	1.2	1.0	1.1	1.2	1.1	1.2	1.2	1.3	1.3	1.3
Refi minimum bid rate (%, eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (%, eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.32	-0.41	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
10-year interest rate (%, eop)	0.50	0.30	0.40	0.24	0.24	-0.07	-0.31	-0.57	-0.50	-0.50	-0.50	-0.40	-0.30	-0.25	-0.25	-0.25	-0.25	-0.20	-0.20	-0.20
Fiscal balance (% of GDP)					-0.5					-0.7					-0.8					-0.7
Fiscal thrust (% of GDP)					-0.2					0.1					0.1					0.0
Gross public debt/GDP (%)					87.8					87.0					85.9					84.9
Japan																				
GDP (% QoQ, ann)	-0.5	2.3	-2.5	1.8	0.8	2.2	1.8	3.8	-4.6	1.3	1.4	0.0	0.9	0.9	0.2	0.9	0.9	0.9	0.9	0.8
CPI headline (% YoY)	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.3	1.5	0.7	2.0	2.0	2.3	1.1	1.8	1.1	1.0	0.9	0.8	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
3-month interest rate (%, eop)	0.00	0.00	-0.05	-0.05	-0.05	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
10-year interest rate (%, eop)	0.05	0.03	0.14	0.00	0.00	-0.10	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20
Fiscal balance (% of GDP)					0.0					-0.2					-0.3					0.2
Gross public debt/GDP (%)					232.8					232.0					230.0					228.0
China																				
GDP (% YoY)	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.1	6.3	6.3	6.0	5.9	5.9	5.8	5.9	6.1	6.2	6.3	6.4	6.3
CPI headline (% YoY)	2.2	1.8	2.3	2.5	2.2	1.8	2.6	2.8	2.6	2.5	2.6	2.6	2.5	2.4	2.5	2.5	2.5	2.5	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
10-year T-bond yield (%, eop)	3.75	3.48	3.63	3.30	3.30	3.07	3.20	3.14	3.30	3.30	2.95	2.90	3.15	3.40	3.40	3.10	3.20	3.40	3.50	3.50
Fiscal balance (% of GDP)					-2.6					-4.5					-4.0					-4.0
Public debt, inc local govt (% GDP)					88					102					103					105
UK																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.3	-0.9	1.6	1.2	1.4	1.1	1.4	1.4	1.2	1.1	1.7	1.3	0.8	0.5	1.3
CPI headline (% YoY)	2.7	2.4	2.5	2.3	2.5	1.9	2.0	1.8	1.8	1.9	2.2	1.7	1.7	1.7	1.8	1.6	1.9	1.9	1.9	1.8
BoE official bank rate (%, eop)	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (%, eop)	0.60	0.80	0.80	0.80	0.80	0.83	0.77	0.77	0.80	0.80	0.85	0.85	0.85	1.10	1.10	1.10	1.10	1.10	1.10	1.10
10-year interest rate (%, eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.50	0.30	0.30	0.40	0.60	0.80	0.90	0.90	0.90	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-1.4					-1.4					-1.2					-1.0
Gross public debt/GDP (%)					86.9					85.7					84.4					83.6
EUR/USD (eop)	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.09	1.10	1.10	1.10	1.12	1.13	1.15	1.15	1.16	1.17	1.18	1.20	1.20
USD/JPY (eop)	107	110	114	113	113	112	108	108	105	102	102	100	100	100	100	98.0	95.0	93.0	90.0	90.00
USD/CNY (eop)	6.28	6.67	6.87	6.88	6.88	6.74	6.90	7.15	7.20	7.20	7.23	7.28	7.30	7.30	7.30	7.27	7.25	7.23	7.20	7.20
EUR/GBP (eop)	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.89	0.83	0.83	0.85	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88
Brent Crude (US$/bbl, avg)	67	75	76	69	72	64	68	62	65	65	60	58	62	67	62	64	70	70	68	68

[1]Lower level of 25bp range; 3-month interest rate forecast based on interbank rates
Source: ING forecasts

Disclaimer